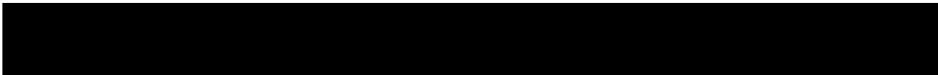


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Assistant Chief Counsel (Tax Litigation) CC:TL



This is in response to your request for tax litigation advice dated May 4, 1989. The discussion section contains proposed language for respondent's brief in the above-referenced case.

#### ISSUE

Whether Notice 89-21, 1989-8 I.R.B. 23, impacts the cap loan issue in the above-referenced case. 0451-1300.

#### CONCLUSION

Notice 89-21 does not affect the cap loan issue.

#### FACTS

On February 7, 1989, the Service issued Notice 89-21. The Notice provides that a taxpayer who receives a lump sum payment with respect to a notional principal contract must accrue the payment as income over the life of the contract. Traditionally, the Service has required a recipient of such a lump sum payment to accrue the income upon receipt. The Notice further states that it draws no inference with respect to loans.

#### DISCUSSION

Despite the issuance of Notice 89-21, Service position with respect to cap loans remains unchanged, i.e., accrual method taxpayers must recognize interest income upon receipt. This position is well supported by case law. See, e.g., Mele v. Commissioner, 61 T.C. 358 (1973); Franklin Life Insurance Co. v. United States, 399 U.S. 1118 (1968).<sup>1</sup> Additionally, Peter Scott, the Acting Chief Counsel, has indicated that the Service will not abandon the cap loan position despite the issuance of

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<sup>1</sup> We note that you successfully distinguished Illinois Power Co. v. Commissioner, 792 F.2d 683 (7th Cir. 1986), in the

the Notice.

Nevertheless, the petitioner's counsel raised the issue of Notice 89-21 at the trial. He argued that our litigating position with respect to cap loans is inconsistent with the Notice. Consequently, we suggest that you discuss the Notice in the brief. We do not recommend a lengthy discussion since the judge appears to be predisposed to ignore the Notice.

We recommend that the following language be inserted into respondent's brief:

Petitioner has raised the question of whether Notice 89-21, 1989-8 I.R.B. 23, impacts upon the cap loan issue. The Notice requires a taxpayer to amortize a lump sum payment received under a notional principal contract over the life of the contract. The Notice applies only to notional principal contracts and provides that "[n]o inference should be drawn from this notice as to the proper treatment of transactions to the extent that they are not properly characterized as notional principal contracts, for instance, to the extent that they are in substance properly characterized as loans." Obviously, cap loans are loans in substance, and, thus the Notice draws no inference with respect to them.

Notional principal contracts are a new type of transaction for which there is no judicial guidance with respect to their tax treatment. The Notice simply attempts to address issues underlying this new type of transaction. It represents the Commissioner's exercise of his discretion with respect to clear reflection of income principles under I.R.C. § 446(b). See RCA Corporation v. United States, 664 F.2d 881, 886 (2d Cir. 1981).

If you have any questions, contact Joan Rood at FTS 566-3521.

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